COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE NOTICE OF LAKE VILLAGE WATER ASSOCIATION, INC., OF A TARIFF AMENDMENT ADJUSTING RATES AND IMPOSING CONSTRUCTION SURCHARGE	))))	CASE NO. 89-075

O R D E R

This matter arises out of a notice by Lake Village Water Association, Inc. ("Lake Village") filed March 31, 1989, pursuant to 807 KAR 5:011, Section 6(3)(b), of an adjustment to its rates to become effective May 1, 1989. By Order of the Commission entered April 26, 1989, the proposed rates were suspended for five months through October 2, 1989. A hearing was held on November 29, 1989 at the offices of the Commission at which Lake Village appeared and was represented by counsel. Based upon the testimony and evidence herein and upon the entire record, the Commission makes the following Findings of Fact, Conclusions of Law, and Orders.

FINDINGS OF FACT

Lake Village is a non-stock, member-owned corporation that owns, operates, and controls facilities for the distribution and sale of water to the public. The company serves communities and developments in the Lake Herrington area of Boyle and Mercer counties. Its principal offices are located in Burgin.

On March 31, 1989, Lake Village filed notice that, effective May 1, 1989, it intended to increase it rates by approximately 25 percent and that, pursuant to the provisions of KRS 74.395, it also intended to impose a temporary construction surcharge of $4.50 per month. The Commission suspended the proposed rates for five months in order to conduct an investigation to determine whether the proposed rates were fair and reasonable. On August 21, 1989, the Commission Staff issued a report recommending that the present rates be reduced by approximately 4.3 percent, but that the construction surcharge be approved. The following is a comparison of the present rate schedule, the rate schedule proposed by Lake Village, and the rate schedule proposed by the Staff, together with the operating revenues each schedule is projected to produce.

Rates Per 1000 Gallons

	Present	Proposed	Staff
First 1000 Gallons	$ 10.26	$ 12.83	$ 9.85
Next 2000 Gallons	3.86	4.83	3.70
Next 2000 Gallons	3.56	4.45	3.40
Next 5000 Gallons	3.26	4.08	3.10
Over 10,000 Gallons	2.96	3.70	2.83
Operating Revenues	$385,365	$481,948	$368,916

To calculate Lake Village's revenue requirements, the Staff used the revenues and the operating expenses and other costs incurred by the utility during the calendar year 1988, which is referred to as the "test year." A limited financial review of

Lake Village's operations was made for the test year and then adjusted to reflect known changes in revenues and expenses.

Operating Revenues

The principal source of income for Lake Village comes from the sale of water to its customers. During the test year, the operating revenue from water sales was $371,230.

Lake Village does not produce any of its own water but instead purchases the water it sells from the cities of Danville and Harrodsburg. During the test year, Danville increased the price it charged Lake Village by 80 cents per 1000 gallons and then later decreased its price by 45 cents per 1000 gallons. To offset these price changes, Lake Village was permitted to adjust its water rates on both occasions so that the increase and the decrease in the wholesale cost was passed on to the consumer. According to Lake Village's billing analysis which was adopted by Staff in its report, annual revenues from water sales under the present rates should increase by $14,135 to $385,365.

During the test year, Lake Village reported income of $27,815 from other sources. One of its other sources of income was Tyler and Tyler Development Company. Tyler and Tyler operates a sewer system and some of its customers are served by Lake Village. During the test year, Tyler and Tyler charged its customers a fee based on their monthly water usage. Tyler and Tyler paid Lake Village $890 for providing it with that information. Since the test year, Tyler and Tyler has changed its rate structure and now charges a flat monthly rate. Therefore, it does not purchase water usage information and Lake Village no longer receives that income.

Lake Village reported earnings of $14,743 from a three year surcharge which was imposed as part of a demonstration project to reduce water loss. The surcharge expired in 1989 and that income will no longer be received.

Even though Lake Village no longer receives revenue from Tyler and Tyler and from the surcharge, it still continues to receive income from sources other than water sales. The Staff Report shows that during the test year Lake Village received income of $12,182 from operations other than water sales. Lake Village should continue to generate this income in the future. Thus, income from sources other than water sales should be reduced from $27,815 to $12,182. As the following illustrates, this amount, together with the revenue from water sales under the present rate structure, will produce $397,547:

<u>Operating Revenues</u>

Water Sales:			
Test Year Actual		$371,230	
Purchased Water Adjustments		14,135	
Total Adjusted Sales			$385,365
Other Revenues:			
Test Year Actual		27,815	
Less: Surcharge	$14,743		
Tyler and Tyler	890	15,633	12,182
Projected Operating Revenues			$397,547

Non-Operating Income

Lake Village reported income from interest during the test year of $3,347. This combined with the projected operating revenues results in total projected revenues of $400,894.

Operating Expenses

Source of Supply Expenses. During the test year, Lake Village purchased approximately 120,795,076 from its suppliers at a cost of $177,505. Of the amount purchased, Lake Village was unable to account for approximately 35 percent. It is a long-standing policy of the Commission, however, not to allow more than 15 percent for water loss for the purpose of determining allowable expense for rate-making purposes. This policy is intended to serve as an incentive to promote efficient management. The disallowance of the excessive line loss of 20 percent will result in a reduction to Lake Village's purchased water expense of $38,283 for rate-making purposes to $139,222.

In addition to the purchased water expense, Lake Village incurred during the test year expenses related to the source of supply, generally referred to as operations supplies and expense, in the amount of $2,217. Thus, the total adjusted source of supply expense is $141,439.

Transmission and Distribution Expense. For the test year, Lake Village reported expenses of $38,162 for maintaining its distribution system. That amount included expenditures of $13,226 for capital improvements which are depreciable assets and not expenses. Thus, Staff reduced Lake Village's reported transmission and distribution expenses by $13,226, the amount of the capital improvements, and the Commission finds that Staff's reduction is reasonable and appropriate. This includes the maintenance of standpipes, mains, service, and meters. The amounts expended in each category are as follows:

Transmission & Distribution Expense

Maintenance of Standpipes	$ 25
Maintenance of Mains	11,099
Maintenance of Services	6,909
Maintenance of Meters	6,903
	$ 24,936

Customer Accounts. Lake Village reported expenses of $14,940 during the test year in maintaining its customer accounts. These expenses consisted of labor to read each customer's meter and supplies and postage for billing each customer. The amounts expended in each category are as follows:

Customer Accounts Expense

Meter Reading Labor	$ 10,979
Supplies and Postage	3,961
	$ 14,940

Administrative and General Expense. During the test year, Lake Village reported $66,168 of administrative and general expenses. One of those expenses was legal costs of $7,572. These costs included a legal fee of $3,569 which covered a billing period of February 19, 1985 through April 13, 1988. Of that fee only $484 represented expenses incurred during the test year. Therefore, Staff reduced Lake Village's legal expenses by $3,085 to exclude legal expenses incurred outside the test year. The Commission finds that this reduction by Staff is appropriate.

In addition, Lake Village included in its legal expenses $1,600 paid to the Mercer Circuit Court for an easement it is seeking to condemn. The cost of the easement, however, is not an expense nor is the easement once acquired a depreciable asset. The Commission finds that this expenditure should be excluded from this account. Therefore, after making adjustments for the legal expenses, Lake Village's administrative and general expenses are $61,483 as shown in the following:

Administrative & General Expense	
Salaries	$ 28,849
Office Supplies	4,603
Insurance	3,628
Miscellaneous	2,983
Payroll Taxes	2,656
Telephone	1,235
Legal	2,886
Audit and Accounting	2,575
Commissioner's Fees	9,000
Utilities	2,560
Licenses and Taxes	507
Total	$ 61,482

Depreciation Expense. For the test year Lake Village reported depreciation expense of $42,414. Not included in this amount were the depreciable assets that were purchased during the test period in the amount of $13,226 and reported incorrectly as transmission and distribution expense. The depreciation attributable to those capital expenditures for the test year is $997, and Staff increased depreciation expense by that amount to $43,411. Staff's increase is reasonable and appropriate.

Capital Investments and Long-Term Debt

Lake Village has invested $1,624,444 in its utility plant and equipment. Of that amount, $1,130,000 is derived from two long-term loans from the Farmers Home Administration ("FmHA"), both of which remain outstanding. The balance of its investments came from contributions from developers, connection fees, membership fees, and similar charges in the sum of $381,789 and from other sources in the sum of $112,655.

The first loan from FmHA was for $610,000. As evidence of that debt, Lake Village executed four separate notes on April 20, 1970, two for the principal sum of $200,000 each, one for the principal sum of $100,000, and one for the principal sum of $110,000. The loan was authorized by a resolution of the board of directors, which by its terms, also constitutes a contract between the association and FmHA. The notes are all payable in annual installments that are due on January 1 of each year in the total sum of $36,161. To ensure that there will be sufficient funds for making each annual payment as it comes due, the resolution requires Lake Village to establish a debt service account and to deposit into that account an amount equal to 1/12th of the next annual installment. Deposits into the debt service account are made from the Revenue Account into which all operating revenues are required to be deposited.

The resolution also requires Lake Village to maintain an "Operations and Maintenance Account" and a "Reserve Account." Funds from the Operations and Maintenance Account are used to meet the reasonable and necessary expenses of the association and are transferred from the Revenue Account.

The Reserve Account is maintained for emergency situations. Each month Lake Village is required to transfer $300 from the Revenue Account to the Reserve Account until the Reserve Account has accumulated $36,000. Under the resolution agreement, funds from this account can only be used to repair or replace damage to the water system facilities which result from unforeseen catastrophes, to make extensions or improvements to the facilities, and when necessary, to make payments of principal and interest due on the loan when there are not sufficient funds in the debt service account for that purpose. To the extent that these payments are used to repair or replace existing facilities, they duplicate a portion of the depreciation expense on those facilities.

Lake Village borrowed an additional $520,000 from FmHA. This loan was also authorized by a resolution of the board of directors adopted on April 4, 1983. Under the terms of this loan, which is evidenced by a single note, Lake Village is also required to make annual payments and to maintain essentially the same accounts that are maintained by the earlier loan. The annual payment, which is due February 1 of each year, is $45,703. Lake Village is required by the loan resolution to make $381 monthly payments to the debt service account until $45,720 accumulates.

In addition to the conditions expressly stated, the loan resolutions require Lake Village to impose and collect rates and charges for its services that are sufficient to provide for the operation and maintenance of its facilities, to meet the installments on the debts, and to maintain the various funds and accounts required by the loan resolution. To ensure compliance with this provision, which is generally found in all its loan agreements, FmHA normally requires that, in addition to the other expenses a utility incurs in operating its facilities, that its rates be sufficient to cover the debt service payment plus 20 percent, in addition to the other expenses normally incurred in conducting the utility operations. Thus, Lake Village has annual debt service obligations under the terms of its FmHA loans as follows:

Annual Principal and Interest	81,864
20%	16,373
	98,237

Summary of Revenues, Expenses, and Debt Requirements

Based on its operations during the test year, Lake Village can reasonably be expected to have operating expenses and debt requirements of $384,445. Against this amount, Lake Village, under its present rate schedule, should realize revenues of $400,894 from all sources. Thus, the present rate schedule will produce revenue that exceeds Lake Village's operating expenses and debt requirement by $16,449 as follows:

<u>Revenues</u>		$400,894
<u>Expenses</u>		
Purchased Water		141,439
Transmission & Distribution		24,936
Customer Account		14,940
Administrative and General		61,482
Depreciation		43,411
<u>Debt Requirement</u>		
Capital Investment & Long-Term Debt		
Annual Principal and Interest	81,864	
20%	<u>16,373</u>	<u>98,237</u>
Total		384,445
Excess		16,449

<u>Water Loss Recovery</u>

Recently Lake Village participated in a water loss demonstration project designed to reduce the volume of unaccounted-for water. Lake Village was allowed a surcharge for three years which it used to reduce its water loss from between 55 percent to 65 percent to approximately 35 percent. The surcharge, which Lake Village reported produced $14,743 annually, expired on December 31, 1988 and Lake Village must now rely upon operating revenues to continue this work.

Because of the topography and geography of the area served by Lake Village, it is difficult to discover leaks in the system. Much of the system is in the Lake Herrington area and the mains pass through ledge rock which consists of seams. Because water that leaks from the mains may follow a seam underground, many leaks are not detectable from the surface. Lake Village would like to continue its efforts to reduce water loss from its current level to not more than 15 percent, but without the surcharge it cannot do so from the revenues produced under the existing rate structure.

Line Replacement

Lake Village has two water lines which it would like to replace. The lines are in two subdivisions, the Herrington Woods Subdivision and the Chimney Rock Subdivision. Both lines were owned by the property owners in the subdivision and were subsequently taken over by Lake Village when the subdivisions became a part of Lake Village's distribution system.

The Herrington Woods line is a two inch galvanized line that does not have sufficient capacity to adequately serve the consumers who receive service from this line. The line has also deteriorated over the years and is releasing iron oxide into the water giving it a reddish color. Lake Village has received complaints about the quality of the water from that line and has been directed by this Commission to undertake actions to correct the problem. Lake Village has obtained an estimate of $65,580 to replace the line.

The Chimney Rock line, which is located in close proximity to the Herrington Woods line, is also in need of replacement. The existing line is in good condition but is unable to carry the volume of water needed by the consumers who receive service from this line. The Chimney Rock line is approximately 1,700 linear feet in length as compared to the Herrington Woods line, which is approximately 800 linear feet in length. It is estimated that it will cost twice as much to replace the Chimney Rock line as it will cost to replace the Herrington Woods line.

The replacement of both lines will take approximately three years. Lake Village has attempted to obtain financing for the construction but has not been able to do so. The association has applied to FmHA for a loan, and the application has been put in a low priority category such that it is not likely to be approved. Conventional sources of funds are also unwilling to provide financing because Lake Village does not have any collateral to offer as security. Therefore, the only source of funds available to Lake Village is from its customers in the form of rates or a surcharge.

Accumulated Cash Deficit

On December 31, 1987, according to its annual audit, Lake Village had accumulated a cash deficit of $41,606 in its operating account and its revenue account and was unable to pay many of its bills as they were received. On December 31, 1988, the deficit was approximately $70,000. Although there is no estimate of what it will be, it is anticipated that the annual audit for 1989 will again show a deficit in the operating account and the revenue account.

Expansion Surcharge

In its notice Lake Village requested a surcharge of $4.50 per month for three years to fund $210,000 of construction. The proposed construction will consist of a 200,000 gallon steel water storage standpipe, 4,400 linear feet of 6 inch water main, and the construction of 1,500 linear feet of 4 inch water main. The construction of the standpipe is scheduled to begin not later than May 1, 1990 with final completion not later than December 31, 1991. Construction of the two mains is scheduled to begin no later than May 1, 1991 and be completed no later than December 31, 1992. The total cost of the project is estimated to be $209,300 and the total revenue estimated to be produced by the surcharge is $211,855.

CONCLUSIONS OF LAW

Lake Village is a utility engaged in the distribution of water to the public. As such, it is authorized by KRS 278.030 to demand, collect, and receive fair, just, and reasonable rates for the services it renders. What constitutes such a rate was defined in Public Service Commission v. DeWitt Water District, Ky., 720 S.W.2d 725, 730 (1986) as follows:

> Unreasonable has been construed in a rate-making sense to be the equivalent of confiscatory. The court has equated an unreasonable rate to be confiscation of utility property. We have declared that rates established by a regulatory agency must enable the utility to operate successfully and maintain its financial integrity in order to meet the just and reasonable non-confiscatory test.

The current rates charged by Lake Village will produce revenues in excess of that required by the utility to meet its operating expenses and maintain "financial integrity." To offset the excess revenues, the rates should be decreased by $16,449, as out in the rate schedule marked Appendix A.

Water Loss Recovery

Lake Village should be permitted to assess its customers a surcharge of $3.83 per month to produce $53,026 annually, for a period not to exceed three years, unless otherwise extended by this Commission. The funds derived from this surcharge should be deposited in a separate water loss interest producing insured account and used exclusively by Lake Village to reduce its water loss from the current level of 35 percent to 15 percent. Before expending any funds from this account, Lake Village should, within 90 days of this Order, submit to the Commission a plan outlining what it intends to do to reduce its water loss. Lake Village should file with the Commission within 30 days of the close of each calendar quarter after the date of this Order a written report containing the amount collected under the surcharge each month during the quarter, the amounts expended to reduce water loss, a description of the work performed, the labor furnished, the materials purchased during the quarter to reduce water loss, and the percentage of water unaccounted for.

The surcharge should be listed as a separate line item on each customer's bill. Failure to file each report when due should warrant suspension of the surcharge and refunding of the revenues on deposit plus interest earned in the account.

Line Replacement

Lake Village has requested that, in addition to the revenues needed to meet its operating expenses, it be allowed to generate an additional $60,000 annually to be used exclusively to replace two existing water lines. The replacement project would take approximately three years at an estimated cost of $180,000.

While Lake Village has established a need to replace these lines, which is identified as the Herrington Woods line and the Chimney Rock line, it has not provided sufficient documentation to verify the cost of the project. Therefore, that portion of the requested increase cannot be approved. Failure to approve the increase does not preclude Lake Village from instituting another rate proceeding with proper documentation to support the increase.

<u>Accumulated Deficit</u>

Lake Village has requested that it be allowed to generate sufficient revenues to offset the deficit in its operating account and its revenue account that is has accumulated in recent years. At the end of the test year, the deficit was approximately $70,000 and had grown approximately $30,000 from the previous year. The current amount of the deficit, however, is not known.

The new rate structure should generate sufficient revenue to meet the current operating expenses and halt any growth in the deficit. The question remains whether additional revenues should be authorized to apply to the existing deficit.

The Commission's policy has been to deny rates that require consumers to pay for past deficits of a utility. Lake Village, while requesting a rate sufficient to retire the deficits, has neither established the amount of the deficit nor proposed a rate that will permit its elimination within a reasonable time and without imposing an unreasonable burden. Nevertheless, even if it had done so, the Commission's policy has been to deny rates that require consumers to pay for past deficits of a utility because such rates constitute retroactive rate-making.

Expansion Surcharge

Lake Village should be permitted to assess its customers a surcharge of $4.50 per month to fund construction of a 200,000 gallon steel water storage standpipe and 4,400 linear feet of 6 inch water main. The surcharge should be for a period of not more than five years. All funds generated by the surcharge should be set apart in a reserve trust account, which should be invested in securities issued or guaranteed by the United States government until they are needed and should be expended, together with any interest or other earnings, solely for the construction of the facilities. If construction does not begin within five years after the surcharge is implemented, all funds collected should be returned to the association's customers, together with interest and earnings. The association should maintain its records in such a manner as will enable it, this Commission, or its customers to determine the amounts to be refunded and to whom they are due in the event that the surcharge amounts are ordered refunded.

Lake Village should file semi-annual statements detailing surcharge revenues collected, including interest earned thereon and all expenditures made. Failure to file this semi-annual report should warrant suspension of the surcharge and refunding of the revenues previously collected.

The surcharge constitutes contributions and should be accounted for in the manner prescribed by the Uniform System of Accounts for Class A and B Water Districts and Associations. The monthly billing should be debited to customer accounts receivable and credited to the contributions account. When the surcharge is collected, special funds should be debited and customer accounts receivable credited.

ORDERS

Now therefore, upon the foregoing Findings of Fact, Conclusions of Law, and upon the entire record, IT IS HEREBY ORDERED:

1. The application of Lake Village to increase its rates by $96,583 be and is hereby denied.

2. Lake Village is hereby directed to decrease it revenues by $16,449 to be generated by the rates set out in Appendix A, which is attached hereto and incorporated herein.

3. Lake Village is hereby authorized to assess a surcharge in the amount of $3.83 per month per customer for the sole purpose of reducing its water loss from 35 percent to 15 percent. At the expiration of the three year period, Lake Village shall immediately cease charging the amount of the surcharge and advise the Commission in writing of the same.

4. Lake Village shall establish a separate water loss insured account to be used exclusively to reduce its water loss and shall account for, dispense, and disburse the funds in the account only in the manner and under the conditions prescribed in the Conclusions of Law herein. If these proceeds are used for any other purpose, Lake Village's authority to assess the customer surcharge shall immediately cease and Lake Village shall refund all proceeds of the surcharge. Improper use of these proceeds

shall also subject Lake Village to the penalties provided in KRS 278.990.

5. Lake Village shall submit to the Commission within 30 days of this Order its plan to reduce its water loss as prescribed in the Conclusions of Law herein and shall further, within 30 days of the close of each calendar quarter, file a quarterly report containing the information prescribed in the conclusions of law herein. Failure to file any report when due shall warrant the suspension of the surcharge and the refund of all amounts collected plus interest earned.

6. The application by Lake Village for a construction surcharge of $4.50 per month for a five year period be and is hereby granted. If these proceeds are used for any other purpose, Lake Village's authority to assess the customer surcharge shall immediately cease and Lake Village shall refund all proceeds of the surcharge. Improper use of these proceeds shall also subject Lake Village to the penalties provided in KRS 278.990.

7. Lake Village shall establish a reserve trust account and shall account for, dispense, and disburse the funds generated by the construction surcharge in the manner prescribed in the Conclusions of Law herein.

8. Within 30 days of the date of this Order, Lake Village shall file with this Commission tariff sheets reflecting the rates and surcharges authorized herein.

Done at Frankfort, Kentucky, this 29th day of January, 1990.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 89-075 DATED 1/29/90

The following rates and charges are prescribed for the customers in the area served by Lake Village Water Association, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

Monthly Water Rates

First 1,000 gallons	$9.85 Minimum Bill
Next 2,000 gallons	3.70 per 1,000 gallons
Next 2,000 gallons	3.40 per 1,000 gallons
Next 5,000 gallons	3.10 per 1,000 gallons
Over 10,000 gallons	2.83 per 1,000 gallons

Surcharges

$3.38 per month for water loss recovery.

$4.50 per month for construction.